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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

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| In the Matter of | ) | |
| | ) | CC Docket No. 94-1 |
| Price Cap Performance Review | ) | |
| for Local Exchange Carriers | ) | |

# REPLY COMMENTS OF BELLSOUTH TELECOMMUNICATIONS, INC.

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## EXECUTIVE SUMMARY

The Commission has an historic opportunity to make a strong and lasting contribution to the nation's economic and social welfare as it encourages the buildout of the National Information Infrastructure ("NII"). BellSouth strongly believes that a major part of this effort must include regulatory and price cap reform. The Commission's current system of LEC price regulation -- which is not yet a "pure" price cap plan but an interim hybrid of direct price and rate-of-return regulation -- can and must be modified if the public interest goals of price regulation, including the deployment of the NII, are to be fully realized.

The present LEC price cap plan distorts important objectives and incentives that price regulation is intended to promote, chiefly through its retention of the vestiges of cost-based regulation -- such as the earnings sharing and low-end adjustment mechanisms and Commission-mandated depreciation prescription. In its initial comments BellSouth proposed a series of revisions to the LEC price cap plan that will improve its performance and thereby ensure that the plan better promotes public policy objectives. These recommended changes included: eliminating the sharing and low end adjustment mechanisms; adopting a lower, more realistic productivity offset based on Total Factor Productivity (TFP); modifying and streamlining rules governing the introduction of new services; revising the LEC price cap basket and banding structure; and ensuring that all customers benefit from growing competition in access services by establishing now the ground rules for streamlining the regulation of LEC services.

The comments received by the Commission thus far have underscored the importance of modifying the price cap plan in order to realize the Commission's important public policy objectives. Nevertheless, certain commenters have sought to deconstruct the clear link between price cap reform and corresponding public policy benefits. In addition, commenters like AT&T and MCI -- whose precise positions (like their pricing) are conspicuously parallel -- are unabashed in their effort to keep the LECs bound within a web of anachronistic regulatory constraints. The proposals of these parties, grounded chiefly on overstated calculations of LEC earnings (that are eminently reasonable in any event) affirmatively contravene the fundamental theory of price regulation and the policy goals of the Commission in this proceeding. Some non-LEC commenters also have urged the Commission to follow a "reactive" rather than an "adaptive" regulatory approach, and advocated stringent regulation of the LECs until some undetermined point in the future -- even as competition continues to expand exponentially in the local exchange.

In the following Reply Comments, BellSouth offers specific rebuttal to and urges the Commission to reject a variety of arguments raised by LEC competitors in connection with specific Baseline and Transition issues. Most of these parties seek only to advance self-serving agendas that will have precisely the opposite public interest effects that the Commission wishes to encourage. BellSouth once again urges the FCC to adopt its proposals for price cap reform, and to allow a pure price cap system to facilitate job-creation, increased productivity, economic growth and the buildout of the NII.

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REPLY COMMENTS OF BELLSOUTH TELECOMMUNICATIONS, INC.

BellSouth Telecommunications, Inc. ("BellSouth"), by and through its undersigned attorneys, hereby submits the following Reply Comments in the above-captioned matter.

## I. INTRODUCTION

In its initial Comments, BellSouth expressed its view that the Commission's experience with price regulation generally has validated the soundness of the Commission's policy judgment four years ago that a properly-designed system of incentive regulation is superior to a rate-of-return-based regime and generates greater consumer benefits.[1] Nevertheless, BellSouth also urged strongly that the Commission revise and refine the current price cap plan for local exchange carriers if the promise of incentive regulation -- and ultimately investment in and buildout of a National Information Infrastructure ("NII") -- is to be achieved. In its present form, the LEC plan distorts and actively undercuts important objectives and incentives that price regulation is intended to promote, chiefly through its retention of the vestiges of cost-based regulation -- such as the earnings sharing and low-end adjustment mechanisms and Commission-mandated depreciation prescription. These elements of the plan are simply incompatible with a system of price regulation that seeks to promote

[1] See LEC Price Cap Order, 5 FCC Rcd at 6789.

efficiency incentives and infrastructure investment.[2] BellSouth's Comments accordingly proposed a series of revisions to the LEC price cap plan that will improve its performance and thereby ensure that the plan better promotes public policy objectives. These recommended changes included:

- Eliminating the sharing and low end adjustment mechanisms, which were never intended to be long-term features of the LEC price cap plan, are no longer warranted, and perpetuate administrative complexity and perverse rate of return incentives that are fundamentally incompatible with price regulation.

- Adopting a more realistic productivity offset in accordance with the Christensen Associates' recent study of Total Factor Productivity (TFP), which indicates that the current productivity offset should be reduced over a full percentage point from the Commission's 1990 estimate (from 3.3% to 2.2% if the 0.5% Consumer Productivity Dividend is added to the Christensen measure of 1.7 %).

- Modifying rules governing the introduction of new services, including reforming the burdensome cost and engineering support requirements associated with the introduction of new services in order to encourage price cap LECs to develop and introduce innovative new services, and amending the Part 69 rules to remove the rate structure requirements associated with switching and common line elements.

- Revising the LEC price cap basket and banding structure to eliminate those price cap constraints which serve no legitimate regulatory purpose, but instead only interfere with the efficiencies and incentives that price caps are intended to create.

- Ensuring that all customers benefit from growing competition in access services by establishing <u>now</u> the ground rules for streamlining the regulation of LEC services using a forward-looking measure of competition.

The commentary received by the Commission thus far has underscored the importance of price caps -- and the concomitant potential of this proceeding to adopt a pure form of price regulation -- in realizing the Commission's expansive public policy

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[2] <u>See</u> Commissioner Andrew C. Barrett, Federal Communications Commission, <u>Beyond Price Caps: Escaping the Traditional Regulatory Framework</u> (Aug. 27, 1992), at 7 ("Specifically, it's time to sever the link we have forged between prices and earnings on a rate base and let the market regulate those prices that it can. And it's time to further streamline the process of regulation so it can cope with the new technologies and industry structure.").

objectives.[3] Indeed, as Professor Robert Harris has explained, the major role of government with respect to the NII is to stimulate private investment; thus, what is needed "is simple and straightforward: a set of adaptive and flexible policies that facilitate balanced competition, that promote efficiency and innovation, and that provide appropriate economic incentives for investment."[4]

Although the price cap reforms recommended by BellSouth advance the objectives identified by Professor Harris, certain commenters, seeking to promote their own agendas at the expense of the public interest, have sought to deconstruct the clear link between price cap reform and corresponding public policy benefits.[5] Similarly, other non-LECs, most notably AT&T and MCI -- whose precise positions (like their pricing)[6] are

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3/ See, e.g., Comments of BellSouth Telecommunications Corp. (May 9, 1994), Attachment 1, John Haring and Jeffrey H. Rohlfs, Strategic Policy Research, Comments on Transition Issues, (April 19, 1994) ("Haring/Rohlfs Report"), at 1 ("Indeed, we are hard pressed to think of any regulatory proceeding (before the Commission) that is as significant as price caps when it comes to efficient deployment of advanced communications technologies and maintenance of a policy framework conducive to efficient competition."); Larry F. Darby, Price Cap Reform, Financial Incentives and Exchange Carrier Investment, in support of USTA Comments (May 9, 1994) ("Darby Report"), at 15 ("However the Commission decides to weave telecommunications capital formation into the fabric of its broader public interest goals, there is one inescapable fact: the price cap revisions it adopts for the LECs in this proceeding will have a dramatic impact on the level and composition of future telecommunications investment.").

4/ Robert G. Harris, "The Economic Benefits of LEC Price Cap Reform," in Support of the United States Telephone Association, CC Docket No. 94-1 (May 9, 1994), at 20 ("Harris Report").

5/ A recent study by the President's Council of Economic Advisors confirms and illustrates the Administration's view that regulatory reform can have a beneficial impact on achieving our macroeconomic goals -- jobs, productivity, incomes and the trade balance. After considering a variety of regulatory reforms that will change the incentives of carriers in the marketplace, the CEA found that such regulatory reforms will boost investment in the telecommunications sector and elsewhere, while generating multiplier effects and induced productivity increases throughout the economy. Executive Office of the President, Council of Economic Advisors, "Economic Benefits of the Administration's Legislative Proposals for Telecommunications" (June 14, 1994) ("CEA Study").

6/ Effective August 1, AT&T raised its rates for residential services by approximately 1% overall and its commercial rates by approximately 3.9%. Exactly one week later, MCI filed a conspicuously parallel -- are unabashed in their effort to keep the LECs bound within a web of anachronistic regulatory constraints that affirmatively contravenes the fundamental theory of price regulation and the policy goals of the Commission in this proceeding.[7] Finally, these commenters have urged the Commission to follow a "reactive" rather than an "adaptive" regulatory approach, advocating stringent regulation of the LECs until some undetermined point in the future even as competition continues to explode in the local exchange.

In the following Reply Comments, BellSouth urges the Commission to reject the arguments of LEC competitors. Proposals of commenters such as AT&T and MCI will have precisely the opposite public interest effects that the Commission wishes to encourage. They will reduce LEC incentives for investment, efficiency and innovation and will perpetuate the outmoded regulatory restraints that prohibit LECs from meeting the access competition that is growing at a phenomenal rate.[8] Moreover, the prescriptions for

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tariff proposing similar rate increases, with a veteran Washington observer remarking that "the rate increases 'don't say much for the level and intensity of competition in the interstate services market.'" Telecommunications Reports (Aug. 2, 1993).

[7] MCI, for example, advocates even "more aggressive" constraints on the LECs, and would, inter alia: increase the LEC productivity factor to 5.9% (as would AT&T) AND require a one-time decrease in LEC price cap indices; retain sharing but eliminate the low-end adjustment mechanism; readjust sharing boundaries to reflect an alleged "contemporary" cost of capital of 9.54%; retain or increase LEC monitoring and reporting requirements; retain an upper limit on new service prices and impose onerous cost showings on new services even when they are first introduced; and use market share as the gauge for triggering streamlined regulation. MCI's proposals strain credulity and would, if adopted, thoroughly eviscerate any conceivable public interest benefits that price caps might otherwise yield. But promotion of the public interest is not MCI's concern. MCI merely seeks regulatory cover for MCI Metro, its "$2 billion venture into the local marketplace to build fiber rings in the leading metropolitan areas of the United States," targeting a "local marketplace worth an estimated 90 billion dollars." Remarks by Bert C. Roberts, Jr., Chairman and Chief Executive Officer, MCI Communications Corporation, Annual Meeting, Washington, D.C. (May 23, 1994).

[8] Robert G. Harris, Reply Report filed in support of USTA Reply Comments on June 29, 1994, at 1 ("Harris Reply Report").

"reactive" regulatory policies "are unfortunate because they stand directly in the path of the National Information Infrastructure":

> [A]t best they will slow the pace of change, at worst, they will impede it. The arguments for reactive policies are so predictable because they so directly benefit those who advance them; competitors who seek competitive advantage by advocating regulatory policies designed to inhibit real competition in access services.
>
> . . . . **The rate of change is much too fast for the Commission to take a "wait and see" attitude, which inevitably means reacting to changes in the market after they have occurred. Instead the Commission should implement adaptive policies that anticipate the direction of change and conform to those changes as they occur.**[9]

## II. BASELINE ISSUES

**Baseline Issue 1: Infrastructure Development**

As BellSouth showed in its initial comments, a significant degree of modernization of the LEC network has occurred to date under price caps. Over the past three years, the eight largest LECs have invested approximately $50 billion in new plant and equipment -- which includes some $8.9 billion of BellSouth investment -- and have exhibited a significant, steady progression in upgrading switching equipment, laying fiber optic cable, upgrading the capacity of their copper plant, implementing new services and technologies, and extending service to non-urban areas. Indeed, a recent FCC analysis of fiber deployment presenting data and associated information on interexchange carriers, RHCs, urban fiber systems and non-Bell local operating companies found that, in contrast to interexchange carriers, who increased fiber by about 5.6% in 1993, local Bell operating companies' deployed fiber grew by about 27% during 1993 and stood at approximately 6.3 million fiber miles at the end of the year.[10] Notably, BellSouth's fiber deployment led all LECs by a

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[9] Id. (emphasis in original).

[10] See Jonathan M. Kraushaar, Fiber Deployment Update, End of Year 1993, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission (May 1994).

significant margin.[11] The FCC's analysis also highlighted BellSouth's recent fiber technology trials, including BellSouth's interoffice synchronous optical network (SONET) trials, SONET 150 megabyte loop trials, and other BellSouth trials involving medical imaging applications.[12]

BellSouth has shown that it is extremely committed to infrastructure development, and believes that over time such development will yield many positive benefits, including the promotion of universal service and educational benefits through a host of interactive applications at home and in the schools. Once again, however, BellSouth views the LECs' positive progression in infrastructure development as relative to the success that can be achieved by modifying the current hybrid price cap plan to be more consistent with the theoretical underpinnings of price regulation. As Dr. Darby has observed:

> The Commission has signalled its intention to foster competitive alternatives to LECs['] networks as the "stick" for increased network investment, while using its price cap rules to provide the opportunity and the "carrot" for doing so . . . The Commission's competitive policies are working. They are providing the "stick" of market discipline to induce LECs to upgrade their networks as a means of remaining competitive. It is equally important that the Commission now recognize the added business risk and provide the "carrot" of adequate market returns to induce investors to provide the necessary capital.[13]

This position is underscored by Professor Harris. Cast in the terms of NII buildout, "[p]rivate investors -- including LEC shareholders -- will not risk their savings unless they are assured that the potential rewards are worth the risk: the government should not expect that wishing for private investment will make it happen."[14] Indeed, as Professor Harris further observes, it is precisely because the United States does not practice classic "industrial policy" by expending large sums of public funds on targeted industries that it is all the more

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[11] Id. at Table 5.

[12] Id. at 17.

[13] Darby Report at 17-18.

[14] Harris Report at 1.

important for the Commission to adopt policies that will attract sufficient private investment in strategic industries. BellSouth agrees with Dr. Harris that this can only be accomplished by adopting policies that are premised on the dynamics of change; that encourage and reward innovation; and that remove regulations which inhibit the deployment of new technologies and the delivery of new services.[15/]

Ad Hoc attempts to create doubt and confusion by attacking the premise that infrastructure benefits will flow from more simplified "pure" price cap rules, and indeed, argues that for the Commission to pursue policies that encourage infrastructure investment would be "misguided, imprudent and perhaps illegal."[16/] This position is absurd. The theory of price cap regulation is grounded on the promotion of proper incentives for LEC behavior. Thus, in shifting to a system of price regulation, the Commission stated its belief that price caps would provide LECs with sufficient incentives to expand network investment in advance of demand, and that the Commission's continuing support of the development of competition through price cap regulation would "provide LECs with the opportunity to continue their efforts to modernize the communications infrastructure and to maintain a level of investment which will lead to the implementation of an intelligent, interconnectable, broadband network."[17/]

Although paying lip service to "competition" and "marketplace forces," Ad Hoc's view is summarized by its attempt to characterize the LEC price cap plan as merely "supplement[ing] the pure 'earnings' basis underlying rate of return regulation with a focus on price levels."[18/] It is clear that, at bottom, Ad Hoc's fundamental quarrel is not with

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15/ See Harris Reply Report at 4.

16/ Comments of Ad Hoc at 7.

17/ LEC Price Cap Order, 5 FCC Rcd at 6830, ¶ 355.

18/ Id. at 3. It is this view, for example, that allows Ad Hoc to argue that removing the earnings sharing mechanism would be a "misuse" of the price caps regime, see Comments of Ad Hoc at 11, rather than viewing sharing as a "backstop mechanism" or necessary midpoint in proposed refinements to the price cap plan, but with the Commission's fundamental policy decision to adopt a system of price regulation for the LECs at all. There is no rational basis for Ad Hoc's extreme views, and for it to succeed in its attempt to reinvent price caps in order to micromanage and centrally plan the allocation of LEC earnings -- rather than allow appropriately configured market incentives to do so -- would be disastrous for the country and counterproductive to the development of the NII.

The Commission's LEC price caps plan to date has functioned adequately, but not optimally. Although "pure" price regulation theoretically seeks to emulate competitive markets, the Commission's hybrid plan continues to impose complex and costly regulatory constraints on LEC earnings that provide far less incentive for LECs to re-invest in price cap services relative to other, less regulated lines of business that offer the potential for greater returns.[19] The Commission can and should address this problem by moving to a pure form of incentive regulation.

**Baseline Issue 2: Composition of Baskets and Bands**

In connection with Baseline Issue 2, the Commission asked whether the price cap basket and band structure should be revised and requested comment on the efficacy of an approach that would realign baskets and bands based on the competitiveness of services. In response, BellSouth recommended modifications to the current basket and band structure that would enhance the performance and efficiency of the price cap plan and thereby better achieve the Commission's price cap policy goals.[20] This includes the goal of promoting

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transitioning the LECs to a purer form of price regulation -- which was clearly the view of the Commission in adopting the LEC Price Cap Order. See FCC Rcd at 6801, ¶ 120 (possible errors in the productivity offset support adoption of a backstop program "at least until we acquire additional experience with LEC price caps").

19/ Sharing mechanisms in particular dull efficiency incentives and suppress efficiency gains. SPR estimates that a 4-year hybrid price cap plan with 50/50 sharing has only approximately 18 percent of the efficiency incentives provided in unregulated competitive markets. SPR Vision Paper at 22.

20/ See Comments of BellSouth at 20-32.

the introduction of new services. The current rigid Part 69 rate structures and complexity of the current basket and banding rules make it difficult to meet increasing customer demand for complex and customized services made possible by new technologies.[21] Customers pay the costs if new services are subject to unnecessary regulatory obstacles that slow their introduction into the marketplace and place unnecessary constraints on their pricing.[22]

Because the purpose of price regulation is to emulate the competitive market, BellSouth observed that the basket and band structure of the price cap plan should afford the LEC the same pricing flexibility that is found in competitive markets irrespective of the level of competition. Accordingly, BellSouth agrees with those parties that believe that competition should not be the criterion for making baseline changes to the basket and banding structure.

Some of the non-LEC parties, however, argue that no change is needed now. MCI and Ad Hoc, for example, assert that the current basket and band structure affords LECs sufficient pricing flexibility.[23] These parties' arguments are grounded on the proposition that until competition develops more fully, the Commission must constrain LEC pricing options. This premise, however, is theoretically wrong and absolutely counterproductive from a policy perspective.

First, the fallacy of the MCI/Ad Hoc position is that it misses the purpose and function of regulation in circumstances of less than full competition. Regulation should act as a surrogate for the market in securing just and reasonable rates. As a regulatory technique, price regulation not only provides a transition mechanism to fully competitive access markets, but also encompasses the zone of reasonableness within which rates should

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21/ See Comments of USTA at 23 n. 51 ("If services are provided, they may not be timely, or they may be offered at prices which preclude market success. All of these factors increase risk and reduce expected return, thus discouraging LEC investment.")

22/ Harris Report at 23.

23/ See Comments of Ad Hoc at 17; Comments of MCI at 16.

fall. For pricing flexibility purposes, the economically appropriate zone is the same as that within which firms in competitive markets operate.

The paper prepared by Dr. John Haring and Dr. Jeffrey Rohlfs of Strategic Policy Research and submitted with BellSouth's Comments explained the illogic of artificially constraining LEC pricing flexibility:

> It makes no sense to argue that firms can be afforded the flexibility to price efficiently within a properly designed zone of reasonableness <u>only if</u> there is competition -- obviously regulated firms should be afforded the same flexibility -- if they are not, they cannot mimic competitive performance. Alternatively, insisting that regulated firms price <u>inefficiently</u> to afford new entrants profitable opportunities for expansion invites overexpansion and creates a moral hazard.[24]

The essence of BellSouth's proposed changes to the basket and banding structure is to eliminate existing price cap constraints that serve no legitimate regulatory purpose and that only interfere with the efficiencies and incentives that price caps are intended to create. To be sure, as competition continues to grow and flourish, additional modifications to the price cap rules will be warranted. The baseline modifications to the basket and banding requirements proposed by BellSouth, however, should not be predicated on the emergence of competition, but should be implemented because they are needed to ensure that the price cap plan has the appropriate attributes to achieve the Commission's goals.

On the other hand, failure to make the limited modifications to the basket and banding structure proposed by BellSouth will perpetuate price regulations that will inhibit, if not prevent, LECs from pricing services at economically efficient levels. Such an outcome is in direct conflict with the intent and purpose of price cap regulation.

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[24] <u>Haring/Rohlfs Report</u> at 5-6. The "moral hazard" to which Haring and Rohlfs refer arises from the reduced incentives for LEC competitors to operate prudently and efficiently when they are shielded from competition. They have little incentive "to avoid error and improve their performance." <u>Id</u>. at 6, n. 10.

Finally, as Professor Harris points out, premising regulatory reforms such as basket and banding revision on full competition is wrong because it ignores the pressing need for the FCC to adopt adaptive regulatory policies. The need for regulatory reform "is based not only on the state of the market, but on the rate of change in the market."[25] Although LEC competitors would have the Commission maintain the regulatory controls of the past well into the future, the accelerating, even daily, emergence of competition in the local exchange counsels enlightened -- and not backward-looking -- regulatory policy:

> The Commission should be asking three fundamental questions: (1) what will the market look like a few years ahead? (2) What do we want the market to look like a few years ahead? and (3) What can and should the Commission do to promote the realization of that vision? The price cap reforms adopted now should be based on answers to those questions, not "what did the market look like in the last year for which data are available?"[26]

Indeed, as Professor Harris suggests, one cannot imagine MCI advocating the same "wait and see" approach in developing and implementing its own corporate policies that it urges the FCC to adopt as sound public policy here. Quite simply, a "wait and see" approach to price cap reform is a premise "sure to fail."[27]

As much as keeping the current basket and banding requirements would detract from the full achievement of the Commission's goals, a greater conflict would arise were the Commission to accept the arguments of those parties who contend that even the current rules afford the LECs too much pricing flexibility. These parties seek rule amendments that would further constrain the way LECs could change the prices of existing services.

Two principal proponents of increased constraints on LEC pricing, MFS and WilTel, base their arguments on the belief that pricing flexibility enables LECs to discriminate in the pricing of their services and permits them to move away from cost-based

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25/ Harris Reply Report at 3.

26/ Id. (emphasis in original).

27/ Id. at 4.

rates. As a solution, each proposes a means of preventing perceived unreasonable rate relationships from developing by establishing a system which tightly controls the movement of LEC service prices.

WilTel proposes a price index system whereby the flexibility to change prices for more competitive services would be permitted provided that LECs adjust prices for less competitive services in a parallel fashion.[28] MFS urges the Commission to replace the service category, subcategory and subindices in the trunking basket with a so-called "cost consistency" approach. This system would apply on a rate element basis and would prohibit the price of any element from varying by more than 10 percent of the average price/cost ratio of the basket as a whole.[29]

These proposals lack any substantive foundation. The perceived discrimination is not based on the existing legal standards, i.e., different prices for like services being charged to similarly situated customers. Instead, MFS and WilTel use the term "discrimination" to describe rate relationships between different services that they view as unfavorable. Implicit in each of these parties comments is a presumption that there is a cost or cost-basis that equates to a price, and only that price can be considered cost-based. For them, it follows that if tariffed rates depart from this single cost-based price, then LECs are engaged in discriminatory pricing or cross-subsidization.

Yet, this fixed price/cost relationship that MFS and WilTel would have the Commission establish is not grounded in economic theory nor is it sound regulatory

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28/ See Comments of WilTel at 22. The stated purpose of indexing would be to fix rate relationships among services. As WilTel points out, the indexing system would require any discounts in higher volume services (e.g., DS3) to be reflected as well in parallel discounts in lower volume services (e.g., DS1). See id. at 22 n.17.

29/ See Comments of MFS at 17-18.

policy.[30] It amounts to nothing more than a formulaic, fully allocated cost approach to rate setting.[31] It cannot be justified or rationalized on the basis of economic efficiency. A formula approach overlooks the fact that demand, i.e., customer willingness to pay and the value the customer places on the service, must enter into the ultimate selection of prices if economic efficiency and consistency with the competitive outcome are to be achieved.[32]

Nor is a formula approach consistent with sound regulatory policy -- especially in the current dynamic technological and market environment where the Commission no longer is free to legislate prices. Use of a formula to set prices may result in prices that are unattainable in the marketplace.[33] And as the access marketplace transitions towards competition, this problem becomes substantially greater.[34]

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30/ For example, MFS's proposed 10 percent mark-up constraint is completely arbitrary. See Comments of MFS at 18. It is equally conceivable that greater or lesser mark-ups will yield more efficient prices. Because the pricing constraint proposed by MFS does not account for whether the resulting prices are efficient, the impact of this constraint could be the potentially bizarre result of requiring LECs to charge inefficient prices. While there is no doubt that such an outcome would benefit MFS, it is difficult to defend as beneficial to consumers.

31/ MFS attempts to disclaim any inference that its cost consistency scheme requires an allocation of overhead or common costs. See id. But the fact that MFS would mandate a consistent mark-up above direct cost is no different in effect than using a fully allocated cost approach to set rates.

32/ There is no dispute that if prices for access services were set at incremental (marginal) costs that such prices would not generate sufficient revenues to cover total costs. The primary reason is the existence of both fixed and sunk costs. The dilemma is how to recover these costs through prices in excess of incremental (marginal) costs. It has been recognized that use of demand information is necessary to optimize economic efficiency. See e.g., Alfred E. Kahn, The Economics of Regulation: Principles and Institutions, Vol. I. Cambridge, Mass: The MIT Press, 1990, pp. 130-137.

33/ The purpose in advocating these formula approaches by some parties is to limit or eliminate LEC pricing discretion. These parties overlook the fact that in some cases lower prices do not result from the exercise of pricing discretion on the part of the LECs, but are instead inevitable and wholly natural consequences of increases in market supply relative to demand. When supply increases relative to demand, it is not so much a question of a firm lowering its price, but of the market making it impossible to sell at a higher price.

34/ MFS's and WilTels comments focus on services included in the Trunking Basket. These are the services in which the Commission has concentrated its efforts to expand and promote competition. Thus, it is an area where a formula approach to setting rates would most likely

The Commission has recognized elsewhere the perverse incentives that fixing rate relationships can cause. In the Local Transport Restructure proceeding, the Commission refused to fix the rate relationships between DS1 and DS3 services.[35] If a LEC had to lower rates for DS1 services every time and to the same extent it lowered DS3 services, a LEC would not lower DS3 rates until it first considered the impact upon its DS1 rates and the consequent impact upon overall revenue gains and losses. Depending on the outcome of this calculus, economic and pricing efficiencies that might otherwise be obtained would be sacrificed because of the operation of an arbitrary regulatory rule. Once again, such a result is contrary to the theory and intent of price cap regulation.

Whether termed "indexing," "cost consistency" or "fully allocated cost," the effect of each of these approaches is to arbitrarily fix rate relationships. Because these approaches sacrifice both efficiency and competition, they are unacceptable. The Commission instead must focus on improving its price cap plan in ways that will promote growth and efficiency. The proposals made by BellSouth are consistent with that end.

**Baseline Issues 3 and 4: Productivity Factor and Sharing**

**A. No Adjustments to the Price Cap Plan Should Be Premised on Changes in Capital Costs**

Baseline Issues 3a and 4a both address whether the impact of changes in capital costs should be reflected explicitly in the LEC price cap plan. Baseline Issue 3a asks, inter alia, whether the Commission should require a one-time reduction in the LEC price cap index and whether the Commission should adopt a mechanism which would adjust the plan to reflect changes in interest rates. Baseline Issue 4a asks whether the sharing and low-end adjustment mechanisms should be realigned with capital costs.

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produce prices that are incompatible with market demand.

[35] See Transport Rate Structure and Pricing, CC Docket No. 91-213, Second Report and Order FCC 94-9 (released Jan. 31, 1994), recon. pending.

Again, not surprisingly, many non-LEC competitors endorsed these suggestions.[36] Most of these parties rely uncritically on reductions in interest rates and/or suspect estimates of LEC capital costs since 1990[37] to justify adjustments to the LEC price cap plan.[38] Among these parties, only AT&T analyzes whether a change in capital costs should be considered for treatment as an exogenous cost under the LEC price cap plan.

Specifically, AT&T recognizes that capital cost changes impact the economy generally. Only if a capital cost change realized by the LECs is not adequately reflected in the GNP-PI should it be considered for treatment as an exogenous cost adjustment to the LEC price cap plan.[39] Stated another way, AT&T recognizes that a capital cost adjustment

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36/ See, e.g., Comments of Ad Hoc at 24-25; Comments of ARINC at 3; Comments of AT&T at 30-33; Comments of CCTA at 2; Comments of GSA at 4; Comments of ICA at 11-13; Comments of MCI at 2, 18, 27-30; Comments of OCCO at 7-9; Comments of Wiltel at 25.

37/ As the testimony of Dr. Randall S. Billingsley, attached to the Reply Comments of USTA, clearly demonstrates, LEC overall capital costs today in fact are higher, rather than lower, than the 11.25 percent prescribed by the Commission in 1990 and incorporated into the base rates for the initial price cap filings of the LECS, even taking into account reduced interest rates. See USTA Reply Comments, Attachment 2, Report of Dr. Randall S. Billingsley at 18 and Exhibit RSB-1 ("Billingsley Report") (concluding that overall cost of capital for LECs ranges from 11.64% to 11.82% with a midpoint of 11.73%, and consequently that LECs current overall cost of capital exceeds the 11.25% rate of return authorized by the FCC for the LECs in 1990 -- even in light of the recent declines in interest rates). Accordingly, the Commission should find the issue moot. Based on Dr. Billingsley's conclusions, the rationale for any proposed cost of capital adjustment to the LEC plan evaporates.

38/ As a threshold matter, it is anomalous even to speak of capital cost adjustments to the price cap plan because the Commission should be moving away from an earnings-based regulatory approach. The FCC can achieve the full benefits of incentive regulation only by eliminating debate over cost of capital and earnings levels, and it is counterproductive for the Commission to continue framing price cap issues according to a rate-of-return regulatory construct. In any event, although BellSouth responds to the arguments of LEC competitors below, the Commission has never given notice or characterized this proceeding as one in which the carriers' rates or rates of return are to be represcribed. The determination of whether the FCC has prescribed a rate is made by assessing the practical consequences of its actions. Nader v. FCC, 520 F.2d 182 (D.C. Cir. 1985). It would be inappropriate, and in fact unlawful, for the FCC to accept the arguments of LEC competitors and "prescribe" a change in sharing criteria without following the procedures set forth in Part 65 of the Commission's rules.

39/ Comments of AT&T at 32.

to the LEC price cap plan should be considered only when the criterion for exogenous treatment is met, i.e., a cost beyond the control of the LECs that is not adequately reflected in the inflation component of the price cap formula.[40]

As numerous LECs, including BellSouth, pointed out in their initial comments, capital cost changes do not uniquely affect the LECs.[41] As the NERA Report notes:

> To lower the price cap index by the change in costs implied by a lower interest rate would effectively double-count a portion of the effect of the cost change. The (assumed) reduction in interest rates reduces costs for other firms in the economy which, ultimately, are flowed through to consumers in the form of lower prices. Lower prices imply that the growth in the measure of national inflation (GNP-PI) is lower than it otherwise would be, and thus that the regulated firm's price cap index would be lower than it would have been, absent the reduction in interest rates.[42]

AT&T acknowledges this fact, but asserts that a capital cost adjustment is nonetheless warranted because the LECs are more capital intensive than the average firm in the U.S. economy, and therefore capital cost changes have a disproportionate impact on the LECs.[43] AT&T's argument should be rejected.

First, LECs are not only capital intensive; they require tremendous use of labor as well. Furthermore, capital and labor are substitutable in many applications. Under

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[40] Policy and Rules Concerning Rates for Dominant Carriers, Memorandum Opinion and Order and Order on Reconsideration, 6 FCC Rcd 665, 674, ¶ 75 (1991); Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, 6 FCC Rcd 2637, 2665, ¶ 63 (1991).

[41] Comments of Ameritech at 13; Comments of BellSouth at 38-39, 47-48; Comments of GTE at 74; Comments of Lincoln at 10-11; Comments of Pacific at 34, 45-46; Comments of Rochester at 18-20; Comments of SWBT at 40; Comments of USTA at 79; Comments of U S West at 38-39.

[42] Comments of USTA, Attachment 5, National Economic Research Associates, Inc., "Economic Performance of the LEC Price Cap Plan" ("NERA Report"), at 25-26.

[43] Comments of AT&T at 33, n. 45. Of course, AT&T and the other IXCs are also capital intensive. Thus, any capital cost adjustment should apply equally to the AT&T price cap plan. Needless to say, AT&T did not suggest a capital cost adjustment in its recent price cap performance review.

the current LEC price cap plan, both capital and labor cost changes are treated as endogenous. Thus, the current plan is neutral with respect to the use of capital or labor, and the LECs have the incentive to use the optimum economic mix of capital and labor to produce their products and services. Adoption of a capital cost adjustment, but not a labor cost adjustment, as an exogenous factor would upset this balance and create perverse incentives for the LECs, thereby reintroducing the very distortions price caps are designed to eliminate.

In the absence of AT&T's proposed capital cost adjustment, when capital costs decline, LECs will have an incentive to increase the proportion of capital deployed in producing their products and services. Likewise, as capital costs increase, LECs have a natural incentive to increase the labor component and reduce the capital component of their cost of production. These incentives are fully consistent with economic efficiency.

Perversely, however, in times of falling capital costs, LECs under AT&T's proposal would have an incentive to reduce the capital component and increase the labor component in order to avoid mandated price reductions not justified by market conditions. Likewise, in times of rising capital costs, LECs would have an incentive to increase the capital component and reduce the labor component so as to achieve additional head room in their price cap indices. Thus, a capital cost adjustment would create uneconomic, perverse incentives for the LECs.

Proposed adjustments to reflect reduced interest rates should also be rejected. In adopting Generally Accepted Accounting Principles ("GAAP") accounting, the Commission has required that LECs expense the cost of refinancing debt in the year incurred.[44/] Such costs are not insubstantial. In 1993 alone, BellSouth Telecommunications, Inc. refinanced $2.76 billion of long term debt at more favorable

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[44/] Such costs include call premiums and underwriting costs for new issues. Under prior Commission policy, such costs were amortized over the remaining life of the issue.

interest rates. An extraordinary loss of $86.6 million was recognized in connection with the early extinguishment of certain of these issues.[45]

In requiring carriers to expense these costs, the Commission has reasoned that the carriers would be able to recoup these costs in part due to the regulatory lag in represcribing the authorized rate of return.[46] If the Commission now adjusts the price cap index to reflect LECs lower interest cost, it will eliminate the ability of the LECs to recover these costs, and destroy the incentives for LECs to refinance high cost debt. Therefore, the Commission should continue to treat changes in interest rates as endogenous under the LEC price cap plan, and reject calls for rate adjustments to reflect changes in interest rates.[47]

In any event, the capital cost adjustments proposed by AT&T and MCI are grossly exaggerated. AT&T argues that the LEC sharing thresholds should be reduced by 132 basis points "to maintain the same relationship" between the current LEC cost of capital and the 11.25 percent used to initialize the LEC price cap rates.[48] However, AT&T blatantly compares apples and oranges to reach this conclusion.

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[45] 1993 Securities and Exchange Commission Form 10-K, BellSouth Telecommunications, Inc. at 23. This extraordinary loss was not included in calculating earnings for purposes of the sharing mechanism; thus, LEC shareholders bore 100 percent of these costs.

[46] See, e.g., In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 6 FCC Rcd 7193 (1991) (observing that "the lower interest rates allow the carriers to lower their embedded debt costs by refinancing outstanding high priced debt"); see also In the Matter of BellSouth, Petition for Waiver of Section 32.4240 of the Commission's Rules to Permit Amortization of Debt Refinancing Expenses, Unamortized Discounts and Premiums Associated with Reacquired Debt Either Over the Life of the Replacement Issue or Over the Remaining Life of the Called Debt Issue, 4 FCC Rcd 387, 389 ¶ 19 (1989) ("Moreover, determinations of allowable rates of return often lag behind the refinancing transaction, producing benefits which can often be offset against a loss recognized in the period the debt is extinguished. Rates of return based on the higher cost debt that has been extinguished remain in effect while the actual interest costs have been reduced.").

[47] The cost of capital adjustments proposed by both MCI and AT&T would capture the full effect of these bond refinancings for ratepayers, even though they were funded by shareholders. Neither MCI nor AT&T even bother to address the equity of their proposals in this regard.

[48] See Comments of AT&T at 33.

When it implemented the LEC price cap plan, the Commission's 11.25 percent prescription represented a point within a range of reasonable rates of return. It was based on the Commission's conclusion that the interstate access cost of equity was in the range of 12.5 percent to 13.5 percent.[49] At that time, however, the application of the annual DCF model to the RHCs produced monthly estimates of the cost of equity averaging 12.19 percent for the six-month period of January-June, 1990.[50] While the Commission placed significant weight on these estimates, it also considered other methodologies and other factors in arriving at its rate of return prescription.

Comparing apples to apples, the 12.19 percent cost of equity estimate produced by the application of the annual DCF model by the Commission in 1990 is only 28 basis points higher than the current 11.91 percent cost of equity calculated by AT&T in Appendix D using the same model -- hardly a dramatic change. Even accepting at face value AT&T's application of the DCF model in Appendix D to its comments,[51] a change in equity capital costs of 28 basis points implies a change in the overall cost of capital of only about 17 basis points, since equity capital makes up approximately 60 percent of the LECs' overall capital structure. The statement of MCI's consultant, Matthew I. Kahal, shows the same thing. Dr. Kahal filed cost of capital estimates in the 1990 represcription proceeding; using the same DCF methodology that he applied in this case, Dr. Kahal estimated the cost of equity capital in 1990 to be in the range of 11.0 to 12.0 percent -- <u>precisely</u> the same

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49/ In the Matter of Represcribing the Authorized Rate of Return for Local Exchange Carriers, CC Docket No. 89-624, <u>Order</u>, FCC 90-315 (released Dec. 7, 1990) ("Represcription Order"), at ¶ 188.

50/ <u>Represcription Order</u> at ¶ 187.

51/ The testimony of Dr. Billingsley demonstrates the errors in the AT&T and MCI cost of capital estimates. <u>See</u> <u>Billingsley Report</u> at 8-19.

range that he calculates in this case.[52] Thus, Dr. Kahal's evidence refutes, rather than supports, MCI's claim that the cost of equity capital has declined since 1990.[53]

When viewed on a consistent basis, both AT&T and MCI demonstrate that there has been no dramatic change in the cost of equity capital of the LECs since 1990. When that fact is combined with the fact that the reductions in the LECs embedded cost of debt were financed by shareowners, not ratepayers, it becomes obvious that there is no legal or equitable basis for the imposition of a capital cost adjustment to the LEC price cap plan. The Commission should therefore reject the capital cost adjustments proposed by AT&T and MCI.

The Commission can maintain an appropriate incentive structure by adopting a "pure" price cap plan for the LECs -- one which does not attempt to fine-tune every possible cost change, but rather gives the LECs unimpaired incentives to reduce costs in order to increase profits. As the NERA Report notes:

> Having adopted an incentive regulation plan, the temptation to fine-tune the annual price cap adjustment formula to account for specific factors that might change short-run costs should generally be resisted; otherwise, price cap regulation would degenerate into traditional RoR regulation, and none of the incentive improvements intended by the adoption of price cap regulation would be realized.[54]

### B. **The Productivity Factor Should Be Lowered**

The Total Factor Productivity (TFP) study performed by Christensen Associates on behalf of the USTA indicated that the baseline productivity offset for price cap LECs initially chosen by the Commission in fact has proven to be too high. Measuring from the time of the AT&T divesture (1984) through the first two years of price caps (1992), the

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52/ Compare Represcription Order at ¶ 128 with Dr. Kahal's Table 9 attached to MCI's Comments in this proceeding. See also Billingsley Report at 8.

53/ Comments of MCI at 29.

54/ NERA Report at 27.

Christensen study calculated that the growth differential between the LECs and the most comprehensive TFP measure published by the Bureau of Labor Statistics has been **1.7 percent**. Thus, even adding in the 0.5 percent Consumer Productivity Dividend ("CPD"), the Christensen result suggests that the LEC productivity offset should be reduced over a full percentage point from the Commission's 1990 estimate to 2.2 percent.[55/]

Several commenters, e.g., AT&T, MCI and Ad Hoc have argued that the LEC productivity offset should be increased, largely based upon claims that LEC earnings have been excessive under price caps.[56/] These arguments should be soundly rejected by the Commission for at least four reasons:

(1) LEC Earnings Were Not Excessive --

Although it is not appropriate to measure the success of price regulation according to rate-or-return based criteria, the record thus far shows that by virtually any reasonable measure LEC earnings have not been excessive. They fall well within the range of normal profits, especially when considered in light of the rapidly increasing business and regulatory risks faced by the LECs.[57/]

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55/ NERA's update of the Commission's original Friendship-Uretsky study yields a virtually identical calculation. Updating the long-term Spavins-Lande study, NERA found that the annual real rate of LEC growth of telephone prices (as measured by the CPI) averaged 1.6 percent over the 1929-1993 period. Thus, if the Commission were to use exactly the same procedures as were used in Docket No. 87-313, incorporating more recent data, NERA calculates that the LEC productivity offset in fact should decline by 0.4 percent. See National Economic Research Associates, Inc., "Economic Performance of the LEC Price Cap Plan: Reply Comments" (June 1994) ("NERA Reply Report"), at 2 (attached to USTA Reply Comments).

56/ The Reply Comments of USTA at 52-60 filed today provide a more detailed rebuttal of each of the revised -- and utterly flawed -- productivity estimates of Ad Hoc, MCI and AT&T, which all advocate an increase in the productivity factor from 3.3% to 5.8-5.9%. See Comments of Ad Hoc at 21, n.21 & Attachment A at 58 n.105; Comments of MCI at 54; Comments of AT&T at 23, Appendix B.

57/ Harris Reply Report at 27. As BellSouth pointed out in its initial comments for example, LEC earnings were in no way excessive when compared to those of AT&T, which averaged about 13.6% from 1990-1993. See Comments of BellSouth at 40.

(2) LEC Reported Earnings Are Biased --

As BellSouth and others showed, the reported profits of the LECs are overstated because (a) the Commission continues to prescribe inadequate depreciation rates that are well below economic levels;[58] (b) the Commission has prescribed a rate base that is below the level of prudently invested capital; and (c) the Commission has adopted numerous rules that require LECs to understate their costs and/or overstate their revenues vis a vis nonregulated firms in the name of "ratepayer protection."[59] These requirements all serve to artificially inflate the earnings reported by the LECs on their "regulated" books.[60]

(3) Productivity Gains Fluctuate Widely in the Short Run --

Professor Harris observes that "one should not draw inferences about long term changes in productivity from short run experience."[61] As BellSouth urged in its

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58/ A comparison between the economic depreciation rates utilized by cable television companies and the rates prescribed by the Commission for the LECs is instructive. Large cable television companies -- TCI, Cablevision, and Comcast -- had weighted average composite depreciation rates of 12.4 percent in 1992. Source: calculated from Value Line Investment Survey, September 1993. By contrast, the Commission prescribed a composite depreciation rate for BellSouth in 1992 of 7.3 percent. The use of regulated depreciation rates that are far below the levels of economic depreciation rates artificially inflates reported regulated earnings.

59/ Comments of BellSouth at 40-41; see also Darby Report at 20; Harris Report at 22; Harris Reply Report at 27-28.

60/ Investors recognize the gross overstatement in carrier earnings occasioned by federal concealment of the true cost of providing interstate access. A recent article in Forbes observes: "By telling the companies to depreciate their assets over long periods of time, the regulators meet both objectives: low rates and the appearance of profitability." Commenting on the decision of U.S. West last year to true up its balance sheet by taking a $5.4 billion pretax charge against earnings, the article notes further:

> In its filings with regulators, U.S. West must still use the old [depreciation] schedules. This means the regulators can deny the company's pleas for higher rates, on the ground that, with current rates, the company is already recovering its costs in a timely manner. Comfortable with this fiction, regulators will move glacially to allow U.S. West -- and other Bell Companies -- to adopt more realistic depreciation schedules.

Riva Atlas, "Honesty Isn't Such a Bad Policy," Forbes (July 4, 1994), at 118.

61/ Harris Reply Report at 28.